DEPARTMENT OF STATE REVENUE

02-20130151.LOF

Letter of Findings: 02-20130151
Corporate Income Tax
For the Years 2008, 2009, 2010, and 2011

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ISSUE

I. Leased Employees – Corporate Income Tax.

Authority: IC § 6-3-2-2(l), (m); IC § 6-8.1-5-1(c); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); 45 IAC 3.1-1-47; 45 IAC 3.1-1-62; 45 IAC 3.1-1-63(B); 45 IAC 3.1-1-63.

Taxpayer argues that the Department of Revenue erred when it included money paid to "leased employees" in its payroll factor.

STATEMENT OF FACTS

Taxpayer is an out-of-state holding company which owns a 100 percent membership interest in several limited liability companies. The LLCs are included as disregarded (pass-through) entities on the Taxpayer's tax returns.

Together with Taxpayer, the disregarded entities operate food and food related businesses in various states including Indiana.

The Department of Revenue ("Department") conducted an audit review of Taxpayer's income tax returns and business. The audit resulted in the assessment of additional corporate income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Leased Employees – Corporate Income Tax.

DISCUSSION

Taxpayer has out-of-state "W-2" employees. For purposes of calculating its corporate income tax, these out-of-state employees create a "payroll factor." The audit found that Taxpayer's remaining Indiana and out-of-state employees were "leased employees."

The audit noted that, "Since there are no W-2 employees in Indiana, the reported payroll factor is zero" because Taxpayer did not include the leased employees in the payroll factor on its Indiana corporate tax returns. In effect, Taxpayer reported no Indiana employees on its Indiana corporate tax return.

Because Taxpayer did not include the leased employees on its Indiana corporate tax return, the audit report concluded that:

> This leads to an unfair representation of the activity necessary to earn income in Indiana, while diluting the overall apportionment percentage by including only W-2 employees in the denominator.

The audit report stated that the failure to include the leased employees in its apportionment formula "leads to an unfair representation of the activity necessary to earn income in Indiana while diluting the overall apportionment percentage by including only W-2 employees in the denominator." As a result, the audit concluded that, "[T]he payroll factor is being adjusted based on the [T]axpayer having both W-2 employees and also leased employees." (Emphasis added).

Taxpayer cites to 45 IAC 3.1-1-63 which states in part:

> Where in the computation of the property, payroll or sales factors, the taxpayer has not assigned part of its property, payroll, or sales to any state, the Department may require the exclusion of the unassigned property, payroll or sales from the denominator of the appropriate factor in order to prevent distortion of the apportionment.

As authority for its decision to include the leased employees in the payroll factor, the audit report cited to IC § 6-3-2-2(l) and (m) the provisions of which state:

> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting;
>
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
>
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
>
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

As supplemental authority, the audit report cited to 45 IAC 3.1-1-63(B) which states:

Payroll. Wages and salaries of employees assigned to fixed locations within this State shall be included in the payroll factor of this State. Wages of personnel operating interstate transportation equipment will be assigned to this State on the basis of total miles traveled in Indiana, as compared to total miles traveled everywhere. The payroll of permanent and transient personnel will then be combined to arrive at the total payroll factor, Indiana payroll over payroll everywhere.

Taxpayer disagrees with the audit's decision to include the leased employees' compensation in its payroll factor and, in response, cites to 45 IAC 3.1-1-62 which states:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results. (Emphasis added).

Taxpayer questions whether its circumstances are "limited and unusual" or that its original apportionment calculation resulted in an "arbitrary division of [its] income" or a "distortion of [its] apportionment."

Taxpayer explains that it pays a related entity – designated here as "Food Service" – for the use of Food Service's employees. Taxpayer concludes that the expense it incurs is not the direct payroll expense of these employees but is a "service fee" paid to Food Service. In addition, Taxpayer points out that Food Service "is directly incurring payroll expense for the employees in Indiana that are leased to Taxpayer . . ." and that – as a result – Food Service is filing an Indiana return. Taxpayer states that Food Service is including the leased employee's compensation in the payroll in Food Service's apportionment formula. Taxpayer concludes that:

[I]mputing payroll for Taxpayer based upon the payroll expense incurred by [Food Service] without adjusting the payroll factor for [Food Service] creates a double counting and therefore double taxation impact of the [Food Service] employees.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A review of Food Services' Indiana tax returns for the years at issue, verifies that the leased employees' compensation is accounted for in Food Services' own apportionment factor. That being said, it is useful to note the regulation which seems to address the question squarely.

45 IAC 3.1-1-47 (repealed Dec. 5, 2012) states in part:

The term "compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded.

Only amounts paid directly to employees are included in the payroll factor. Amounts considered aid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that such amounts constitute income to the recipient under the Internal Revenue Code. (Emphasis added).

The audit included the leased employees in the payroll factor based on IC § 6-3-2-2(l), (m). However, given that Taxpayer is not the immediate employer of the employees and that the leased employees' compensation is accounted for in Food Services' Indiana tax returns, it is unnecessary to take additional steps to "effectuate an equitable allocation and apportionment of the [T]axpayer's income" by including those same amounts in Taxpayer's own apportionment formula. Under these particular circumstances, Taxpayer has met its burden under IC § 6-8.1-5-1(c) of establishing that its original return fairly reflects and reports the income derived from sources within Indiana and that these are not the "limited and unusual circumstances" which justify departing from the standard apportionment model.

FINDING

Taxpayer's protest is sustained.

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